Supreme Court, U.S.
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No. 02-1543

In the Supreme Court of the United States

UNISYS CORPORATION,
Petitioner

v.

COMMONWEALTH OF PENNSYLVANIA,
BOARD OF FINANCE AND REVENUE,
Respondent

ON PETITION FOR WRIT OF CERTIORARI TO THE
SUPREME COURT OF PENNSYLVANIA

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether petitioner carried its burden of proving that the application of Pennsylvania's franchise tax led to a "grossly distorted result," "out of all appropriate proportion" to the business it transacted in Pennsylvania?

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STATEMENT OF THE CASE

Petitioner, Unisys Corporation, claimed in the state courts that Pennsylvania's scheme for taxation of foreign business franchises unconstitutionally subjected it to tax on income generated outside Pennsylvania. In its petition, Unisys asks the Court to review a decision of the Pennsylvania Supreme Court which held that Unisys failed to meet its "heavy burden" of proving that the state tax resulted in a violation of the Due Process or Commerce Clause.

1. The Pennsylvania Franchise Tax is imposed on the Capital Stock Value of Foreign Corporations doing business in Pennsylvania. The statute defines capital stock value as the average of 75% of net worth and capitalized average net income, subject to a fixed deduction. Pa. Stat. Ann., tit. 72 §7601(a) (Purdon 2003). The corporation's net worth includes net worth of subsidiaries, whether or not they do business in Pennsylvania, but net income is assessed on a separate company basis, and does not include income from subsidiaries, though it does include dividends from them.

Once capital stock value is calculated as the tax base, a statutory formula is applied to apportion the value attributable to business activities in Pennsylvania. The taxpayer may elect to use either a "single factor" or a "three factor" apportionment formula. Under the single factor method, the tax due is calculated by the following formula:

$$\frac{\text{Total assets minus exempt assets}}{\text{Total Assets}} \times (\text{Actual value}) \times (\text{tax rate}) = \text{Tax due}$$

Exempt assets include real and tangible personal property outside Pennsylvania. App. 137a, n.4. The "three factor" apportionment formula applicable to foreign corporations calculates the average of three fractions:

Property in PA	Payroll in PA	Sales in PA
Property Everywhere,	Payroll Everywhere,	Sales Everywhere

The property, payroll and sales figures used in the apportionment formula pertain only to the taxpayer corporation itself, and not to its subsidiaries. After the tax base is reduced by the apportionment factor, the tax is calculated by applying a millage rate to the taxable value.

The Pennsylvania Tax Code also includes a "safety valve" provision available to a taxpayer who demonstrates that the franchise tax is unfair in its application. Pa. Stat. Ann., tit. 72 §7401(3)2.(a)(18) (Purdon 2003). If the allocation and apportionment provisions "do not fairly represent the extent of the taxpayer's business activity in [the] State," the taxpayer may petition the Secretary of Revenue to use some other method of calculating its taxes "to effectuate an equitable allocation and apportionment of the taxpayer's income." *Id.*

2. Unisys elected to use the "three factor" formula and calculated its tax base without regard to value attributable to its subsidiaries. In settling Unisys' franchise tax, the Department of Revenue took into account value of investments in subsidiaries and dividends paid by them in establishing the tax base, but did not include the subsidiaries in applying the three factor apportionment formula, which pertained only to Unisys itself. Unisys claimed this had the effect of distorting its tax liability by increasing the taxable value by 44.5%, and it filed petitions in the Board of Finance and Revenue arguing that the tax violated the Commerce and Due Process Clauses of the United States Constitution as well as Pennsylvania statutory law. The Board denied the petitions, and Unisys appealed to Commonwealth Court.

Commonwealth Court held, in a 5-2 decision, that Unisys had not demonstrated that its rights under the Due Process or Commerce Clause were infringed, but that it nevertheless was entitled to adjustment of its tax pursuant to the "safety valve" provisions of the Tax Code. The Court analyzed the constitutional issues within the framework of *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983) and *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980), and concluded that Unisys failed to meet its heavy burden of proving by "'clear and cogent evidence' that the income attributed to the State is in fact 'out of all appropriate proportions to the business transacted . . . in the state" or has "led to a grossly distorted result.'" App. 142a.[1] Commonwealth Court concluded that the "distortion" Unisys claimed as a result of the statutory apportionment formula — 44.5% beyond what would be calculated by using actual value, was well within the limits allowed by this Court. Commonwealth Court noted that the Court had disapproved formulas resulting in distortions of more than 250% and 166% in *Hans Rees'* and *Norfolk and Western Railway*, respectively, but had implicitly approved, in *Moorman*, a variation of 48%. Commonwealth Court went on to conclude, however, that while any discrepancies wrought by the formula were not of constitutional proportions, they were still sufficient to require statutory relief.

The dissenting judge agreed that the franchise tax was constitutional as applied to Unisys, but disagreed

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[1]The Court quotes *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 274 (1978), which in turn quoted *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123, 135 (1931) and *Norfolk & W. Ry. Co. v. Missouri State Tax Comm'n.*, 390 U.S. 317, 326 (1968).

that it was entitled to statutory relief.[2] He believed that Unisys should not be heard to complain about the three factor formula, since it had elected to use it instead of the single factor formula which he said would have resulted in a lower tax. App. 156a. He also believed that Unisys "has offered no reason as to how the tax, as applied to it, is 'unfair' other than saying if the tax was calculated its way, it would be less and, as a result, the tax as imposed is unfair." App. 157a.

The Pennsylvania Supreme Court reversed, in a 4-3 decision, agreeing that the tax imposed on Unisys was constitutional, but also concluding that it was not entitled to statutory relief. The state supreme court decided the case on what it viewed as Unisys' failure to meet its burden of demonstrating that the apportionment formula, applied to it, was inequitable, and of failing to provide the court with sufficient information to construct a "baseline" by which any claimed distortion could even be measured.

The state supreme court recognized that this Court has placed the burden of showing that a tax is unconstitutional on the taxpayer: "[T]he Court restricts the impact of theoretical attacks upon all but the most arbitrary of formulae by generally limiting the inquiry to the relatively minimal test of internal consistency, while preserving the opportunity for taxpayers to more meaningfully challenge apportionment applications by demonstrating a substantial disparity between the tax burden imposed upon them and some reasonable baseline measure." App. 23a. The court concluded that a taxpayer must "account for the methodology by which a tax base is calculated in establishing a baseline for

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[2]Judges Pellegrini and Doyle dissented, but only Judge Pellegrini wrote an opinion, in which Judge Doyle did not join.

purposes of external consistency assessment," App. 28a, and held that Unisys failed to meet its burden:

> In summary, Pennsylvania's scheme for taxation of foreign business franchises may be less than ideal and, absent statutory fairness adjustment, unconstitutional in some applications. Nevertheless, a taxpayer alleging Commerce and Due Process Clause violations bears a substantial burden to demonstrate by clear and cogent evidence that the state is taxing income earned outside its jurisdiction. *See Container Corp.*, 463 U.S. at 169-70, 103 S.Ct. at 2942-43. Here, Unisys has presented baseline figures predicated solely upon full factor representation of subsidiaries, while failing to establish an adequate correlation between the hybrid, adjusted tax base ascribed to it and factor representation on such terms. Pursuant to the standards crafted by the United States Supreme Court, we conclude, therefore, that Unisys has failed to carry its heavy burden. For much the same reasons, we reach the same result on consideration of the statutory fair apportionment provisions.

App. 29a-30a.

Justices Nigro and Newman each wrote dissenting opinions. Justice Nigro believed that the Pennsylvania scheme was inherently flawed, though he also observed that "While Pennsylvania's scheme will no doubt produce constitutional results in some instances, the practical effect of such a scheme on other occasions is the unconstitutional taxation of out-of-state value and impermissible double taxation." App. 41a. Justice Nigro

believed that the majority placed too heavy a burden on Unisys to demonstrate its claim that the tax was unfair as applied to it, and disagreed that Unisys used "unreasonable methods in calculating the tax base in comparison to the Department's methodology," believing that "the fact that Unisys calculated its franchise tax liability with full factor representation while failing to compensate for the 'hybrid' nature of the franchise tax base is not necessarily fatal to its entire claim." App. 43a-44a. He also believed that the majority erred in "giving substantial weight to Unisys's actual franchise tax liability in addressing its constitutional claim." App. 44a.

In her dissent, Justice Newman would have held that the taxing scheme was unconstitutional because "it has the potential to tax extra-territorial income." App. 54a.

REASONS FOR DENYING THE WRIT

The Court should decline to grant the writ because the Pennsylvania Supreme Court's decision is an unremarkable, straightforward, and fact-intensive, application of the Court's well established principles for analyzing Commerce Clause and Due Process Clause challenges to apportionment formulas. Other state courts do not seem to have difficulty in applying these principles, and there is no significant conflict among them.

1. Although petitioners insist that Pennsylvania's three factor apportionment formula is necessarily unconstitutional because it is "asymmetrical" — including value associated with subsidiaries in the calculation of the tax base but not the apportionment formula — the Pennsylvania Supreme Court rightly recognized that this Court has not entertained *theoretical*

challenges to taxing statutes. This Court has instead recognized that "the three factor formula is necessarily imperfect," *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 184 (1983), and has placed the burden squarely on the taxpayer of proving that the income apportioned to a state is "out of all appropriate proportion to the business transacted in that state." *Id.* at 181.

Petitioner's assertion that their burden of proof can be satisfied by merely pointing to the asymmetry of the taxing formula is not only at odds with the Court's decisions, it is simply incorrect. It is not true that Pennsylvania's three factor formula, considered in the context of the entire statutory scheme, *necessarily* results in an unconstitutional tax. First of all, petitioner elected to use this formula, rather than a single factor formula which, in the opinion of at least one judge, would have resulted in the exclusion of "most of its subsidiaries" from the tax base, and a tax that was "considerably lower." App. 156a. Secondly, although the tax base includes value of subsidiaries and the three factor apportionment formula does not, the Tax Code also provides for a flat reduction of 25% of the net value of a taxpayer who uses the formula. It is certainly possible that in some cases this reduction may more than offset the value associated with subsidiaries which is included in the tax base. Finally, there is a statutory "safety valve" by which a taxpayer can petition to have its tax reduced if the formula generates an unfair result. Thus, in order to determine whether petitioner had been unconstitutionally taxed, it *was* necessary to inquire into the facts specific to its case. This, and the Pennsylvania court's conclusion that the factual record was insufficiently developed, make this case a poor candidate for review by the Court.

The state supreme court concluded that the petitioner failed to provide sufficient evidence from which

the court could determine if Pennsylvania's formula caused a "distortion" resulting in an unfair tax. The court made no broad or sweeping conclusions regarding the taxing scheme, even conceding that it "may be less than ideal and, absent statutory fairness adjustment, unconstitutional in some applications." App. 29a. Its decision was very narrow, focusing on petitioner's failure of proof. The state supreme court concluded that it could not properly analyze petitioner's claim because petitioner failed to establish a proper baseline for measuring disproportionality. Specifically, the court found that petitioner had failed to take into account the statutory 25% reduction in net worth allowed unitary enterprises like Unisys, noting the undisputed "need for a taxpayer, addressing a tax base that incorporates unitary aspects but is substantially hybridized and adjusted, to account for the methodology by which the tax base is calculated in establishing a baseline for purposes of external consistency." App. 28a. This, the state supreme court concluded, Unisys failed to do, instead "present[ing] baseline figures predicated solely upon full factor representation of subsidiaries, while failing to establish an adequate correlation between the hybrid, adjusted tax base ascribed to it and factor representation on such terms." *Id.*

The case is therefore too fact intensive to present a clear constitutional question by which the Court could announce a principle of broad application. The precise holding of the Pennsylvania Supreme Court is that Unisys has failed to produce sufficient evidence to meet its burden of proof, which, correct or not, is a question of fact. Thus, resolution of this case is not likely to result in any rule of broad application.

2. Contrary to petitioner's suggestion, the state courts do not appear to be having difficulty following the Court's guidance regarding tax apportionment formulas.

Petitioners point to decisions of state courts in Maine and Wisconsin which, they say, present a conflict with the Pennsylvania decision which the Court should resolve. The conflict to which they point is overstated. The Wisconsin Court in *American Telephone and Telegraph Co. v. Wisconsin Dept. of Revenue*, 143 Wis.2d 533, 422 NW.2d 629 (1988) did indeed hold that that state's apportionment formula violated the Due Process and Commerce Clauses, but, like the Pennsylvania court, it recognized that this Court imposed no bright-line rule as to what a constitutional apportionment formula must contain and rejected AT&T's claim "that a fair apportionment formula must include in the property factor the value of its investments in its subsidiaries." *Id.* at 551-52, 422 NW.2d at 636-37. The court invalidated the Wisconsin formula because it found that "far too much income" was apportioned to Wisconsin, and that the state taxes imposed on AT&T were "grossly disproportionate to the benefits conferred." *Id.* at 551, 422 NW.2d at 636. The Pennsylvania court used the same approach, and presumably would have reached the same result had the record supported it, saying only that it could draw no proper conclusions based on the record, and therefore deciding that the taxpayer failed to meet its burden of proof. This is certainly not a direct conflict.

Similarly, the Maine Court in *E.I. DuPont De Nemours & Co. v. State Tax Assessor*, 675 A.2d 82 (Me. 1996), held that the statutory formula in that case did not violate the Commerce and Due Process Clauses, but again the Court cited *Container Corp.* and *Barclays Bank v. Franchise Tax Bd.*, 512 U.S. 298 (1994) in recognition of the difficulty facing the states in devising apportionment formulas, and the consequent rule that "rough approximation" and "some degree of arbitrariness" may be constitutionally tolerated. The court said only that failure to adjust the apportionment factors to account for a taxpayers activities within and without the

state "*may* result in the taxation of extraterritorial value, and, therefore, *may* run afoul of the fairness principles of the Due Process Clause." 675 A.2d at 89 (emphasis added). Again, this is consistent with the approach of the Pennsylvania Supreme Court.

There does not appear to be any real difference in approach, though outcomes of course may differ depending on the facts, and what each court makes of the record before it. There is no need for further guidance by the Court at this time.

CONCLUSION

For the foregoing reasons, the petition should be denied.

Respectfully submitted,

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